ECONOMIC BENEFITS OF PERFORMING A §1031 EXCHANGE

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While many investors have heard of §1031 exchanges and have some understanding of the economic benefits of performing a §1031 tax deferred exchange, many do not grasp the extent of the benefits available. Summarized below are the most significant economic benefits which may be derived from performing a §1031 exchange. These benefits apply as long as there is taxable capital gain to defer and no offseting capital loss.

Benefit 1: Defer Capital Gain Taxes. Investors may believe this is statng the obvious but not so. First, it is long- term Federal capital gain taxes that are being deferred and such taxes are deferred, not forgiven unless one dies in which case all accumulated capital gain tax is eliminated as one's heirs receive a stepped up basis in the assets inherited (under 2009 tax laws). This does not eliminate estate taxes which are separate taxes requiring separate consideration. In addition, included in the taxes deferred if a §1031 exchange is performed are taxes due to depreciation recapture. An understanding of the economic benefits of such deferral requires an understanding of the Federal taxes an investor would incur if appreciated real property is sold without performing a §1031 exchange. Under the tax structure in place as of January, 2009, most investors will pay tax on long- term capital gains at the rate of 15%. However, to the extent the gain is derived from the sale of a depreciable real property that was depreciated by the investor, the calculation of capital gain tax requires first calculating taxation at the rate of 25% up to the the total amount of depreciation taken. Capital gain above the amount depreciated is taxed at the rate of 15%. All such Federal taxes are deferred if a §1031 exchange is performed and the investor satisfies all other §1031 requirments. In addition, many states, including New York and New Jersey, tax long- term capital gains. Fortunately, most states provide for §1031 exchange tax deferral at the state level and will treat state capital gain taxes as deferred as well. Likewise, some localities, such as Manhattan and its boroughs, impose a long- term capital gain tax on the sale of real property within such areas. Manhattan and its boroughs also permit deferral of local capital gain taxes in a §1031 exchange. Considering Federal, State and local taxes, the total tax an investor will likely pay on the sale of real property in New York if a §1031 exchange is not performed could easily exceed 30% of the capital gain (derived from aggregating a blended rate of 25%/15% Federal, 6-8% State and 3.8% local taxes, if applicable). This means an investor with total gain of $1.5 million could easily pay taxes of around $500,000. If a taxable sale occurs, the $500,000 paid to the IRS and local taxing authorities is lost forever and represents a loss of the investor's hard earned equity. In contrast, by performing a §1031 exchange, all of this equity remains with the investor and available for purchasing a better performing replacement property. Accordingly, §1031 is essentially an interest- free loan from the IRS and local taxing authorities. Most incredible of all, this loan has no due date. Accummulated gains will generally not be taxed unless and until the property is sold without performing a §1031 exchange.

Benefit 2: Increase Purchasing Power. Since investors performing a §1031 exchange do not pay capital gain taxes, they have greater funds available to purchase replacement property. With a larger down payment, a greater number of properties can be purchased or a single property of greater value. Of course, this presumes some leverage is used.

Benefit 3: Diversify Your Investment Portfolio. A §1031 exchange permits investors to diversify investments by buying property located in different geographic areas within the US and also by buying different types of asset classes. Iinvestors may sell in a highly appreciated market and buy in a growth or depressed market where dollars may go further. Investors may also own properties of diverse asset types, such as industrial, residential, office and retail and trade among asset types as their respective values change. Diversifying both geographically and asset –wise also can be used as a form of risk management so an investor does not have all eggs in one basket.

Benefit 4: Consolidate Your Portfolio. Just as §1031 exchange permits investors to diversify, it also permits investors to consolidate. So if an investor owns too many properties or owns properties in more geographic areas than desired, an investor can sell multiple properties in different areas and purchase one larger replacement property to simplify management responsibilities. Alternatively, investors can also sell properties of different asset classes and purchase one or more properties of the same asset class to increase effeciencies and focus efforts.

Benefit 5. Partial §1031 Exchanges Permitted. What if an investor needs funds for another purpose or has a capital loss they would like to offset with a portion of the gain from the sale of property? An investor may partially cash out on the sale of property and still perform a partial §1031 exchange. For example, let's say an investor incurs a long- term capital loss in 2009 of $200,000 and the investor is selling property for $1 million with a gain of $500,000. In such case, the investor may elect to trade down into a property of $800,000 while receivng $200,000 in cash directly at closing. In this example, the capital gain taxes that would otherwise be due on the $300,000 of capital gain are still deferred. Tax due on the $200,000 pocketed by the investor would likely be offset by the $200,000 loss that was incurred. It is essential that investors in such circumstances consult with their legal and tax advisors before proceeding as there are many complex issues to consider in determining whether capital gains may be offset by losses and to what extent offseting is permitting under current tax laws. An investor may likewise wish to perform a partial §1031 exchange if the investor requires funds to be immediately available for another use.

Benefit 6. Capital Gain Tax Liability Disappears on Death. Many investors use §1031 exchanges as a method of estate planing. By continuing to perform §1031 exchanges during one's lifetime, investors can preserve 100% of the equity and appreciation in their properties and ensure that these benefits are transferred to their beneficiaries without being diluted by capital gain taxes. As mentioned above however, estate taxes may be due on the value of the properties in the estate so it is essential that investors also consult with an estate advisor.

Benefit 7: Defering Taxes When One's Basis is Less Than Outstanding Debt. Unfortunately, there are times such as the present when a certain number of investors will find debt on their property far exceeds the amount they can handle and that they are unable to sell the property for the amount needed to pay off the debt. Such investors may be faced with foreclosure. Worse, these investors may end up with a tax liability if the property is taken by the lender in full satisfaction of the outstanding debt to the extent the debt owed on the property is in excess of the investor's basis. A §1031 exchange may provide a solution to this dilemma if the lender will agree to a deed in lieu of foreclosrue and the investor is capable of buying replacement property within the 180 day exchange period of equal or greater value to the property relinquished to the lender. This generally means that the investor will at least need to have cash on hand sufficient for the down payment on the replacement property and be able to finance the balance. Performing a §1031 exchange under such circumstances will allow the investor to defer capital gain taxes at a critical time.

Benefit 8: Flexible Timing Options. §1031 has evolved to the point that an investor can now elect to sell and then buy (a delayed exchange) or buy and then sell (a reverse exchange) and still perform a §1031 exchange as long as the investor properly structures the transaction and engages the services of a Qualified Intermediary. By having flexibility on the timing of both the purchase and the sale of properties, investors can select the format that will most likely yield the best economic result. In other words, if prices are currently deflated, an investor may prefer to buy now and sell later. While under the current safe harbor rules for these types of transactions, the time between the purchase of replacement property and the sale or relinquished property cannot exceeed 180 calendar days, the ability to sell and buy as much as 180 days apart may still provide valuable planning options, flexibility and important economic benefits to investors.

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